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In the Supreme Court of the United States

OCTOBER TERM, 1972

No. 71-1022

UNITED STATES OF AMERICA, *Petitioner*

vs.

JAMES A. BASYE and EVELYN E. BASYE, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

Amicus Curiae Brief In Support Of Respondents

IDENTIFICATION OF AMICUS CURIAE AND STATEMENT OF INTEREST

Kaiser Foundation Health Plan, Inc. ("Health Plan") is a California nonprofit corporation that operates a prepaid hospital and medical care program in Northern California as well as in other regions of the United States. The Internal Revenue Service has ruled that Health Plan is exempt from taxation under Section 501(c)(4) of the Internal Revenue

Code of 1954. Today the Health Plan serves more than 2,400,000 people. At the time of the events giving rise to this action it was serving more than 900,000 individuals.

The ultimate objective of the retirement plan that is the focus of this controversy was to insure that Health Plan, by offering an attractive retirement income to long-service physicians associated with The Permanente Medical Group ("Medical Group"), would have a stable and reliable group of physicians to provide medical services to Health Plan members. Obviously Health Plan's objective will be frustrated if setting aside funds to provide this deferred retirement income results in a current tax to the physicians.

Counsel for the parties in this matter have given their consents to the filing of this brief, and their letters advising of their consent are filed herewith.

STATEMENT OF FACTS

Health Plan contracts to arrange comprehensive medical and hospital care for its members. To fulfill this responsibility to its 390,000 members in its Northern California Region, Health Plan entered into an agreement effective as of July 1, 1959, with a partnership of physicians, Medical Group, under which Medical Group agreed to provide medical services for Health Plan members in Northern California. This agreement reflected the contemplated establishment of a retirement plan for all physicians associated with Medical Group, whether the individual physician was an employee or a partner.

In December 1959 the retirement plan was established as contemplated, and thereafter Health Plan made payments to the trust which was created for this retirement plan. The payments into this trust give rise to the controversy here.

The primary purpose of the retirement plan was to create an incentive for physicians to remain with the Medical Group, or other groups of physicians contracting to serve Health Plan members, and thus insure Health Plan that it

would have a stable and reliable group of physicians providing medical services to its members with a minimum of turn-over, whether the services were performed in Northern California or other areas in which it serves members. The retirement plan was patterned after one which had been established in Southern California between Health Plan and a partnership of physicians serving Health Plan members there. The payments, the taxation of which is in question here, would not have been paid by Health Plan except for the purpose of funding the retirement plan. (R. 83-84).

To serve its primary purpose, the retirement plan provides that the physicians supplying services to Health Plan members may receive benefits only upon fulfilling conditions of continuous service for a minimum period of time with the Medical Group or another medical group serving Health Plan members. Thus, Dr. Nadia Sorokowski, one of the respondents herein, forfeited her rights in September of 1963 when she terminated her membership in the Medical Group and did not become associated with another medical group serving Health Plan members. During the taxable years 1960, 1961, 1962 and 1963, there had been credited to Dr. Sorokowski's tentative account in the trust an aggregate amount of $6,797.32, which, upon her withdrawal from the partnership, was forfeited by her and reallocated to the tentative accounts of the then participants in the retirement plan. The Government would tax Dr. Sorokowski in each of the years mentioned on the amounts credited to her tentative account despite the fact that she never had a right to receive these payments, never did receive them, and never will receive them. (R. 87).

Further, a participant will forfeit his benefits after having become eligible to receive them if he renders professional services for a competitor of Health Plan or if, while able to do so, he refuses to render consulting services to Health Plan or to its affiliates.

Finally, if the Medical Group is dissolved or reorganized, and if at least 50% of the participants in the retirement plan reassociate with the new group or with another group serving Health Plan members, the trust fund remains intact and unretired participants who do not join the new group forfeit the amounts tentatively credited to their accounts. Thus no individual participant, whether an employee or a partner, has anything more than a conditional and tentative interest in amounts credited to his account. It is, moreover, entirely possible that none of the persons who were partners or employees of Medical Group in any year in which a payment is made will ever receive any portion of such payment.

SUMMARY OF ARGUMENT

The Government seeks to tax respondents currently on amounts they have not received, never have had the power to receive and may never receive. In response we have four main points.

1. *Lucas v. Earl*, 281 U.S. 111 (1930), holds that tax liability cannot be shifted by an anticipatory assignment of income. This principle applies only where, but for the assignment, the assignor would have had power to receive the income. The doctrine of *Lucas v. Earl* is not applicable here because it is stipulated that the contributions to the trust were not otherwise available to Medical Group or to its individual members or employees. This Court recently observed that "... the assignment-of-income doctrine assumes that the income would have been received by the taxpayer had he not arranged for it to be paid to another ..." *Commissioner v. First Security Bank of Utah*, 405 U.S. 394, 404 (1972). The essential point is that the amounts involved here never were in the control of Medical Group or any physician, and neither Medical Group nor any physician ever had the power to arrange for them to be paid to another.

1. The contributions to the trust conferred upon the participants mere contingent and forfeitable claims which under long-standing authority do not constitute income taxable currently. *Schaefer v. Bowers*, 50 F.2d 689 (C.A. 2, 1931), *cert. den.* 284 U.S. 668; *Harold Perkins*, 8 T.C. 1051 (1947), *acq.* 1947-2 Cum. Bul. 3; *Julian Robertson*, 6 T.C. 1060 (1946), *acq.* 1946-2 Cum. Bul. 4. The Government acquiesced in two of these cases and won the third.

2. The case is no different because respondents do business as partners rather than as sole proprietors. Since the inception of the income tax, partners have been taxed as individuals. This principle was recognized and confirmed by this Court in *Neuberger v. Commissioner*, 311 U.S. 83 (1940). The contingent and forfeitable nature of the contributions to the trust is not affected by the manner in which respondents chose to do business.

3. Affirmance here will not open the doors to subversion of the statutory scheme relating to qualified deferred compensation plans, and will not open the doors to tax avoidance. Qualified plans confer substantially greater tax benefit than the benefits which are claimed here by reason of the principle of cases which have stood without challenge for decades, that the contingent and forfeitable rights of participants in the retirement plan are not taxable currently. The unique facts of this case, moreover, that the entire structure of the plan was designed to benefit Health Plan and to treat employees and partners equally, that the contributions in question were "not otherwise available" to respondents and that further service to Health Plan was required to vest benefits in any individual, all distinguish this case from the case of a taxpayer who takes the initiative in sponsoring a deferred compensation plan, rather than acting as a mere agent contracting on behalf of certain individuals.

ARGUMENT

I. Lucas v. Earl Does Not Apply.

The principle of *Lucas v. Earl*, 281 U.S. 111 (1930), is that the tax on an amount that would otherwise be taxable cannot be avoided by an anticipatory arrangement initiated by the party otherwise entitled to the amount. That is, if the natural flow of income is thus interrupted and diverted to another through the exercise of dominion and control over it, for tax purposes the diversion is ignored. Application of the principle is premised on a finding or assumption that, *but for* the anticipatory arrangement, the assignor could have received income.

We have no quarrel with *Lucas v. Earl*, but this is not a *Lucas v. Earl* case. Here, the contributions were made to the trust not because Medical Group desired it, but because Health Plan, the source of the funds, would not have it otherwise. The parties stipulated (R. 83-84):

> "The primary purpose of the retirement plan was to create an incentive for physicians to remain with Medical Group, or other groups of physicians contracting to serve Health Plan members, and thus to insure Health Plan that it would have a stable and reliable group of physicians providing medical services to its members with a minimum of turn-over. The retirement plan was patterned after one previously established in Southern California between Health Plan and a partnership of physicians serving Health Plan members in its Southern California Region. The payments which Health Plan agreed to, and did make to the trust, were paid *solely to fund the retirement plan, and were not otherwise available to Medical Group or to the individual members or employees thereof.*" [Emphasis added]

Thus, in this case neither the taxpayers nor Medical Group had any right to a payment over which it could exercise

dominion or control, nor did it have the right to receive any payment. Accordingly, the principles enunciated in *Lucas v. Earl* can have no application. As this Court said in *Commissioner v. First Security Bank of Utah*, 405 U.S. 394, 403-404 (1972):

> "In cases dealing with the concept of income, it has been assumed that the person to whom the income was attributed could have received it. The underlying assumption always has been that in order to be taxed for income, a taxpayer must have complete dominion over it. 'The income that is subject to a man's unfettered command that he is free to enjoy at his own option may be taxed to him as his income, whether he sees fit to enjoy it or not.' *Corliss v. Bowers*, 281 US 376, 378 (1930).
>
> "It is, of course, well established that income assigned before it is received is nonetheless taxable to the assignor. But the assignment-of-income doctrine assumes that the income would have been received by the taxpayer had he not arranged for it to be paid to another...."

The Government suggests (Pet. Br. 13) that this case is not different from *Lucas v. Earl* because in neither case did the taxpayer have the right to receive the payments in question. However, this analysis ignores the fact that in *Lucas v. Earl* the barrier to receipt of the funds was self-imposed by the party otherwise entitled to them, and that *but for* the anticipatory assignment the amounts there involved clearly would have been income taxable to him. In this case neither Medical Group nor any physician had the right, present or prospective, to receive the amounts in question except as they become payable under the terms of the retirement plan.

Whether the Health Plan-Medical Group retirement arrangement and the payments thereunder gave rise to cur-

rently taxable income obviously is the ultimate issue, but it is not a *Lucas v. Earl* issue. Rather, it is an issue to be resolved according to general principles relating to realization of income that we discuss below. If application of these principles should produce the conclusion that there is a realization of income here, then the income is currently taxable for that reason, not because of *Lucas v. Earl*. If, on the other hand, there is no item that would have been such income in the absence of an anticipatory arrangement, as we maintain, then the *Lucas v. Earl* principle never is reached, because as stated this principle is premised on a finding or assumption that, *but for* the anticipatory arrangement, the assignor could and would have received income. There was no assignment here; because nothing could have been received, nothing could have been assigned.

II. The Payments In Question Do Not Constitute Currently Taxable Income.

Whether there was current income has two aspects, namely (1) whether the amounts in question were available to Medical Group or to any physician other than through the retirement plan, and (2) if not, whether contributions to the trust nevertheless represent current income to the respondents. We will discuss these two questions in order.

A. The first question was settled by the stipulation, already referred to, that Health Plan's contributions to the trust were ". . . paid solely to fund the retirement plan, and were not otherwise available to Medical Group or to the individual members or employees thereof." (R. 84). Neither Medical Group nor any individual physician had any right to increased current compensation in exchange for decreased contributions to the retirement trust. As has been stipulated, the Health Plan's contributions to the trust were available in the form offered or not at all. The absence of

the right to receive these amounts was not a constraint self-imposed by the party sought to be taxed, as it was in *Lucas v. Earl*, but rather a constraint imposed by Health Plan in order to serve Health Plan's purposes.

B. The rights of any participant in the trust contributions are contingent and forfeitable until the very moment they are paid out in the form of retirement benefits. There are three cases holding that forfeitable and contingent contributions such as these do not produce current income. *Schaefer v. Bowers*, 50 F.2d 689 (C.A. 2, 1931), *cert. den.* 284 U.S. 668; *Harold Perkins*, 8 T.C. 1051 (1947), *acq.* 1947-2 Cum. Bul. 3; *Julian Robertson*, 6 T.C. 1060 (1946), *acq.* 1946-2 Cum. Bul. 4. The Government did not contend in the Court of Appeals that these cases were incorrectly decided (Pet. 37), nor does it make that contention here; it simply dismisses these cases as irrelevant (Pet. Br. 22). They are irrelevant, the Government suggests, because the contracting party is a partnership rather than one or more individuals, an asserted basis for distinction that is incorrect, as we discuss below.

For present purposes we would only emphasize that these cases, in which the Government has acquiesced,[1] establish that nothing would be taxed to any individual here had no partnership existed. Under *Schaefer*, *Robertson* and *Perkins*, nothing has been received or is receivable and there is nothing that attains the status of "income", whether the question is viewed as being statutory or governed by general legal principles established by the courts relating to the realization of income.

There is no question but that the contributions to the trust were intended as additional compensation for ser-

1. The acquiescences were in *Robertson* and *Perkins*, which are Tax Court cases. *Schaefer* is a Second Circuit case that the Government won.

vices, but the Government errs (Br. 7) in speaking of these contributions as compensation for services "of the partnership". The Health Plan agrees with the principle that "income must be taxed to him who earns it", but here the retirement benefits have not been earned by Medical Group, but will ultimately be earned by those individual physicians who serve Health Plan members over a long period of years, whether or not they continue their association with Medical Group.

The Health Plan had good business reasons for establishing a deferred compensation plan for physicians as an important feature of its nonprofit, community-service health care program. (R. 83-84). At the same time, tax consequences are seldom a matter of indifference, and there obviously would have been no value in Health Plan's sponsoring a retirement plan if it were to mean ruinous tax consequences for the physicians to whom it was intended to appeal as an economic incentive.

The only authorities that were available to Health Plan regarding the probable tax consequences of the retirement plan it had in mind were the cases discussed above. They are not Supreme Court cases, but their holdings are compatible with the concept of income as it has been developed by this Court since 1913.[2] The Government tacitly acknowledged as much when it acquiesced in them a quarter of a century ago.

III. Partners Are Taxed as Individuals.

Since the inception of the income tax, partners have been taxed as individuals. Subchapter K of the Internal Revenue

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2. For example: "In cases dealing with the concept of income, it has been assumed that the person to whom the income was attributed could have received it." *Commissioner v. First Security Bank of Utah*, 405 U.S. 394, 403 (1972).

Code deals with partners and partnerships and begins with Section 701:

> "A partnership as such shall not be subject to the income tax imposed by this chapter. Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities."

Partners do not incur income tax liability that they would not incur as sole proprietors in similar circumstances, and *Schaefer, Perkins* and *Robertson* are no less available to respondents as partners than they would be to respondents as sole proprietors.

In *Neuberger v. Commissioner*, 311 U.S. 83 (1940), this Court permitted a partner to offset his share of partnership profits from securities sales against his individual securities losses, just as if he had executed all his securities transactions in his individual capacity. *Neuberger* resolved a conflict between *Johnston v. Commissioner*, 86 F.2d 732 (C.A. 2, 1936), and *Craik v. United States*, 31 F. Supp. 132 (Ct. Cl. 1940). In *Neuberger* this Court approved *Craik*, which involved a nonresident alien who was a member of two American partnerships that derived a portion of their income from sources outside the United States. The statute provided that the gross income of a nonresident alien included only income from sources within the United States. The Court concluded that the amounts in question were not gross income to taxpayer because it was "... convinced that Congress intended that partnership income should be treated as though it had been received by the partners individually." *Craik v. United States*, 31 F. Supp. 132, 135.[3]

The Government has frequently relied upon and received the benefit of the principle of *Craik* and *Neuberger*. See

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3. The Internal Revenue Service has ruled that the effect of *Neuberger* was to affirm *Craik*. Rev. Rul. 55-415, 1955-1 C.B. 412.

Lief J. Sverdrup, 14 T.C. 859 (1950); *Foster v. United States*, 329 F.2d 717 (C.A. 2, 1964); *Randolph Products Co. v. Manning*, 176 F.2d 190 (C.A. 3, 1949); *Commissioner v. Paley*, 232 F.2d 915 (C.A. 9, 1956), *cert. den.* 352 U.S. 838; *Commissioner v. Ammann*, 228 F.2d 417 (C.A. 5, 1955); and *A. A. Emmerson*, (1965) 44 T.C. 86.

The Government nevertheless purports to dismiss *Schaefer*, *Robertson* and *Perkins* by its assertion that the *partnership* was "irrevocably compensated" by Health Plan's contribution to the trust (Pet. Br. 22). This assertion ignores the forfeitable nature of the partners' interest in the contributions, ignores the partnership's inability to exercise control over the contributions, and ignores the possibility that no partner or employee whose services were allegedly "irrevocably compensated" by a given contribution may ever receive any portion of such contribution. Thus, the Government here asks this Court to tax respondents currently solely because they elected to conduct their affairs as partners rather than as individuals.

IV. The Decision Below Does Not Permit Circumvention of the Limitations Upon Qualified Pension Trusts.

The Government suggests that affirmance would invite wholesale circumvention of the statutory requirements for obtaining the benefits of qualified deferred compensation plans. This is not so.

This case involves the application of principles established by *Schaefer*, *Robertson* and *Perkins*. These decisions have been accepted and presumably applied in the administration of our income tax for many years. They are based upon the concept that a mere right which is contingent and forfeitable, thus being completely dependent upon future events, cannot rise to the status of taxable income. It is ludicrous for the Government to argue now that they pre-

not a serious threat to revenue, particularly when the Government has acquiesced in two of these decisions and won the third with the argument made here.

The qualified pension trusts which are provided for in Section 401 of the Internal Revenue Code of 1954 confer substantially greater benefits than does the retirement plan here. Thus in a qualified pension trust the tax is deferred even if the employee's interest is fully vested and non-forfeitable. Regulations § 1.402(a)-1(a)(1)(i). The Government does not explain how the statutory scheme is frustrated by a plan that provides significantly lesser benefits than those available under a qualified plan. We do not see how it is.

Finally, the Government's concern that partnerships of any size and in any business may establish similar plans to avoid tax on whatever portion of their compensation they choose to defer (Pet. Br. 24) ignores a set of facts probably unique to this case. Health Plan was responsible for health care over a wide geographic area, and required a stable pool of experienced physicians to serve that whole area. To meet that requirement, they offered deferred and forfeitable compensation to individuals, whether partners or employees, and whether or not those individuals maintained a relationship with Medical Group, so long as they maintained a relationship with Health Plan. This deferred and forfeitable compensation was "not otherwise available", and the Medical Group could not change the form in which it was offered. The facts of this case present the rare situation where a partnership acts as a mere agent, implementing a deferred compensation plan which is designed to assure the long-term services of individuals for the payor. Affirmance here can hardly affect many other situations, and will certainly open no doors to tax avoidance.

CONCLUSION

There is no question of income escaping taxation in this case. It is recognized by all concerned that Health Plan's contributions are to be subjected to income tax at some time. The question here is whether the contributions should be taxed currently to Medical Group partners, as the Government demands, or later, to retired participants, on the sums actually distributed to them from the trust.

Respectfully submitted,

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October 2, 1972